



Economic & Investment Update – January 2019

The December quarter was marked by a notable increase in market volatility and a pull-back in most equity markets as positive sentiment that had held markets afloat during 2018 dissipated.

The increase in volatility resulted from a culmination of a number of factors including a decline in global economic growth, continuing trade tensions between China and the US, a normalisation of US interest rates, a tightening of liquidity, and issues impacting specific US stocks and sectors including the technology sector, which has been a key growth engine of the US market.

In the US, economic data releases remained strong and the US Federal Reserve lifted rates (to a range of 2.25-2.50%) as markets had anticipated. However, there were signs that the US economy was losing momentum amid a widening trade deficit, sluggish business spending and housing market weakness. Markets became concerned that the US Federal Reserve would raise rates too far. US President Donald Trump's decision to shut down the government over a stalemate on his \$US5.7 billion border wall proposal also rattled markets.

In Europe, while economic growth continued to disappoint, Brexit dominated news as investors reacted to increased political risk as a key vote was delayed and Theresa May battled a leadership challenge. Markets also reacted to political and social unrest in France and the expected decline in liquidity following the end of the European Central Bank's asset purchase programme.

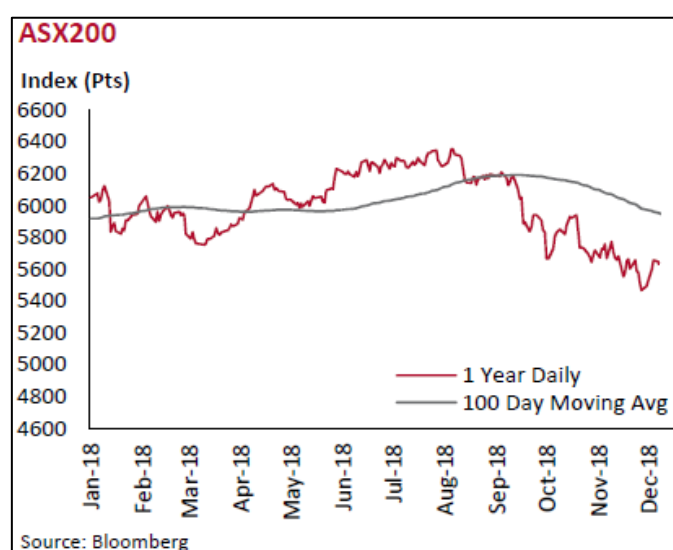
China's economic momentum slowed, driven by the domestic factors and the ongoing trade dispute between China and the US. In response, the People's Bank of China cut the reserve requirements for the country's commercial banks, effectively injecting US \$117 billion of liquidity into the banking system. Authorities also began to ramp up stimulus spending, approving a US\$125 billion rail project, which would add 6,800 km of track.

In Australia, 2018 marked the 27th consecutive year in which Australia's economy grew, recession free. However, it was not all good news for the Australian economy with GDP missing expectations as private consumption slowed sharply and business investment declined. A decline in house prices also caused concerns on the possible impact on the boarder economy. The Reserve Bank of Australia (RBA) continued to keep rates on hold at 1.5%, unchanged now for over two years.

MARKETS

With increased market volatility, the Australian Equity market fell sharply over the December Quarter with the S&P/ASX 200 index down 8.2% (-2.8% for the 2018 calendar year).

All market sectors finished the quarter lower, Although some recorded smaller losses than others. Utilities was the best performing sector (-3.1%), Driven by AGL's strong performance (+5.6%); Whilst the Energy sector (-21.6%) was the worst. Investors remained concerned over the earnings outlook for Energy companies on the back of the drastic decline in the oil price, which dropped by 38% over the December quarter. The Consumer Discretionary (-14.2%), Information Technology (-14.1%) and Telecommunications (-10.9%) sectors also finished more than 10% lower for the December quarter.



Small cap stocks underperformed the large cap sector, returning -13.7% for the quarter with growth stocks in this market segment hit the hardest. Losses during the December quarter within small cap stocks led to an annual return of -8.7%.

Internationally, global stocks also fell with the MSCI World ex-Australia Index (AUD Hedged) returning -13.6% for the quarter and -7.6% over the last 12 months. With the Australian dollar weakening, returns in Australian Dollar terms were slightly better with a -11.1% return for the quarter and 1.5% for the calendar year.

During the quarter, the best performing market was Hong Kong (down 7.0% as measured by the Hong Kong Hang Seng Index) while the Japanese market was the worst performing (down 17.0% as measured by the Nikkei 225 PR Index) as a strengthening yen and the imposition of tariffs on China weighed on Japan's performance. In the US, share markets were spooked by unexpected reporting results from Amazon, Alphabet and Apple with the S&P 500 down 14.3% and the technology focussed NASDAQ down 17.4%.

Domestic listed property continued to outperform the broader equity markets returning -1.9% for the December quarter and 2.9% over calendar year as the outlook for interest rate rises softened and bond market yields fell. However, international listed property falls were greater and the sector returned -5.8% for the quarter and -4.0% over 12 months. Global Infrastructure was also lower, down 4.0% for the quarter and -5.8% for the calendar year.

With heightened volatility leading to falls in domestic yields, Australian bonds (as measured by the Australian composite index) produced a solid return of 2.2% for the quarter and 4.5% for the calendar year. However, credit securities produced slightly lower returns as credit spreads widened. The global composite bond index produced a return of 1.7% for the December quarter as US bond rates also fell.

The table below (sourced from Lonsec) summarises the returns from a number of market sectors.

Sector	Index	3 mths (%)	1 year (%)	5 years (% p.a.)
<u>Equities</u>				
Australia	S&P/ASX 200 TR (Accumulation) Index	-8.2	-2.8	5.6
	S&P/ASX Small Ordinaries TR (Accum) Index	-13.7	-8.7	5.6
International	MSCI World ex Aust NR Index (AUD)	-11.1	1.5	9.8
	MSCI World ex Aust NR Index (AUD Hedged)	-13.6	-7.6	7.4
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	-4.9	-5.1	6.6
<u>Listed Property</u>				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	-1.9	2.9	12.3
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	-5.8	-4.0	7.1
<u>Infrastructure</u>				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	-4.0	-5.8	7.8
<u>Currencies</u>				
AUD v USD	Against US Dollar	-2.4	-9.7	-4.6
<u>Fixed Interest</u>				
Australian	Bloomberg Ausbond Composite All Maturities	2.2	4.5	4.7
	Bloomberg Ausbond Credit All Maturities	1.5	3.9	4.8
International	Bloomberg Barclays Capital Global Agg TR Index (AUD Hedged)	1.7	1.7	4.8
<u>Commodities</u>				
Gold	Gold – USD	7.7	-1.6	1.3
Oil	WTI Oil \$/b – USD	-38.0	-24.8	-14.3

Economic & Investment Outlook

While global economic conditions remain robust, growth appears to have peaked with global GDP projected to slow marginally from 3.7% in 2018 to 3.5% in 2019-20.

However, the current economic and investment environment is coming off a period of extraordinary gains supported by accommodative monetary policy, liquidity being pumped into global markets via quantitative easing as well as some sugar hits in the form of corporate tax cuts in the US.

With the removal of these stimulus measures, policy makers are now seeking to steer their economies carefully towards sustainable, albeit slower, GDP growth while navigating global headwinds.

Continued trade tensions remain and have heightened uncertainty for businesses. It also risks disrupting global value chains and investment, especially in regions tightly linked to the United States and China. It is likely that trade frictions will continue to dominate the minds of investors until an agreement is reached between China and the US.

The trajectory that the US Federal Reserve follows in 2019 with respect to further tightening is also likely to significantly impact global equity market outcomes. US Fed chair Jerome Powell appears to have moderated his views in response to recent market turmoil and has pledged to be patient when it comes to further rate increases in the 2019 year. Media speculation regarding a US recession is likely to continue, particularly given the current inversion of US treasury yields (historically, a reliable predictor of an impending recession).

In Europe, the March Brexit deadline for the UK's divorce from the EU is likely to create ructions as investors fret about the potential of a 'no-deal' Brexit. Theresa May's most recent Brexit deal was defeated in parliament, meaning a new deal will need to be negotiated and voted on before the deadline (unless an extension is agreed to by the European Commission). The success or failure of any deal will determine whether the resultant transition is highly chaotic or relatively seamless for both the participants and global equities markets.

In China, while concerns about a slowdown remain, China recently announced the fifth cut in the bank reserve requirement ratio for this cycle, while also pledging an as-yet unspecified stimulus package centred on tax cuts and rebates for some industries. The impact on growth is likely to be felt from mid-2019.

In Australia, following a slowdown in household consumption, the outlook remains uncertain due to low income growth, high levels of household debt and declining property prices. However, the RBA still expects steady growth in consumption supported by robust labour market conditions and a gradual pickup in wage growth. While the RBA has previously maintained that the next interest rate move is up, some analysts are now projecting an easing in policy should market conditions deteriorate.

Australian Shares

We recommend investors hold a neutral position in Australian Equities relative to their benchmark allocation.

While corporate profitability has been in good shape, it is potentially undermined by regulatory and political issues, including the release of the banking royal commission report in February and the litany of proposed taxation changes associated with a possible change of Government at this year's Federal election. These together with continued weakness in housing present continued uncertainty for Australian investors.

From a valuation perspective, while Australian equity valuations improved during the year-end sell-off, they did not become compelling. The forward price to earnings ratio (PE) briefly dipped below historical averages, however, the positive start to the year has pushed the market back above this metric.

Global Shares

We recommend investors hold a neutral to underweight position in International Equities.

Despite gains in January, the same factors that made 2018 a poor year for equity markets are likely to continue to weigh on markets in 2019, as many of the key issues remain unresolved. Britain continues to try to negotiate Brexit, trade tensions between the US and China continue to simmer while China's economic outlook is still uncertain. However, dips in global equity markets could be seen as a buying opportunity for those with surplus cash holdings.

While commodity prices have supported the Australian dollar in recent months, further interest rate rises in the US could lead to the Australian Dollar depreciating against the US Dollar. For the short term, we prefer international equity portfolios to be unhedged.

Property

We recommend investors hold a neutral position to domestic and global property relative to their benchmark allocation.

In Australia, listed property is now priced on a dividend yield of 5.5%. While the PE ratio of 16.6 times earnings is well ahead of its average (13.4 times earnings), the sector continues to be supported by low domestic interest rates. Office and industrial cap rates will also likely compress further in the next reporting period (on the back of recent transaction evidence), but asset valuation uplift thereafter will depend on income growth and tenancy retention.

Following negative returns in the December quarter and falling bond yields, global listed property now appears relatively attractive.

Fixed Interest

We recommend investors hold an underweight position to Australian Government Bonds and a neutral to underweight position to Global Government Bonds relative to their benchmark allocation. While bond markets produced relatively strong returns over the December quarter as a result of a reduction in bond yields, we believe that future returns will be modest.

Within credit markets, while corporate fundamentals on balance are healthy for the bulk of investment grade issuers, the sector remains expensive. We therefore recommend an underweight position.

Sources: Lonsec

Please note that the information above is general in nature and does not take into account your personal circumstances, financial needs or objectives. Before acting on this information, you should consider its appropriateness having regard to your objectives, financial situation and needs. In particular, you should speak to Kevin Smith of The Professional Super Advisers on (02) 9955 5800 prior to acting upon this information.

